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No. 15-649

In the Supreme Court of the United States

CASIMIR CZYZEWSKI, *et al.*,
Petitioners,

v.

JEVIC HOLDING CORP., *et al.*,
Respondents.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

BRIEF OF *AMICUS CURIAE* STATES OF ILLINOIS, ALASKA, ARIZONA, CALIFORNIA, CONNECTICUT, GEORGIA, HAWAII, IDAHO, INDIANA, IOWA, KANSAS, KENTUCKY, LOUISIANA, MAINE, MARYLAND, MASSACHUSETTS, MICHIGAN, MINNESOTA, MONTANA, NEVADA, NEW HAMPSHIRE, NEW MEXICO, NEW YORK, NORTH DAKOTA, OHIO, OREGON, PENNSYLVANIA, RHODE ISLAND, SOUTH CAROLINA, TENNESSEE, TEXAS, UTAH, WASHINGTON, WEST VIRGINIA, AND WYOMING, AND THE DISTRICT OF COLUMBIA IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Whether a bankruptcy court can authorize a settlement that provides for dismissal of the bankruptcy case and distribution of settlement proceeds in a manner that is inconsistent with the Bankruptcy Code's priority scheme.

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INTEREST OF THE *AMICI CURIAE*

This case presents the question whether some of the parties to a bankruptcy case may agree to settle the distribution of estate assets outside the established priority system of the Bankruptcy Code (the "Code"), *see* 11 U.S.C. § 507, as a prelude to dismissal of the case. The lower courts here approved a settlement that directed settlement proceeds to certain creditors while excluding other creditors who had higher priority under the Code. Allowing such settlements creates an unbounded process that was not authorized by Congress and that undermines the priority scheme at the heart of the Code.

The *Amici* States are deeply concerned about the ramifications of this approach because they are entitled to assert priority status under the Code for their taxes, *see* § 507(a)(8),[1] as well as for other types of claims they can assert either directly or on behalf of their citizens. For example, § 507(a)(1) provides a first priority to claims for domestic support obligations whether asserted by the government for individuals or on its own behalf. Sections 507(a)(4) and (5) provide a priority for prepetition wages and benefits.[2]

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[1] Unless otherwise noted, all references to sections in this brief are to sections of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*

[2] Many States, under numerous statutes including minimum wage laws, equal pay acts and state worker adjustment and retraining notification acts (WARN Acts) have the power to assert claims on behalf of workers. *See, e.g.*, Illinois Minimum Wage Act, 820 ILCS 105/1 *et seq.* (under § 12, the Director can enforce minimum wage claims for employees); Illinois Equal Pay Act of 2003, 820 ILCS 112/1 *et seq.* (under § 30, the Director can enforce claims of individuals); New York Labor Law § 218 (Commissioner has power to enforce payment of wages, minimum wage and other claims for employees); New York Worker Adjustment and

And § 507(a)(7) similarly grants a priority to consumer deposits that can be enforced by governmental entities.[3]

The most significant priority claims asserted by State governments are, of course, claims for taxes. The Federation of Tax Administrators conducted a survey of all fifty States in connection with its September 1996 report to the National Bankruptcy Review Commission. That report, with virtually all States reporting, showed that the States had pending

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Retraining Notification Act, New York Labor Law, § 860 *et seq.* (under § 860-f, Commissioner has power to collect on behalf of employees); Wash. Rev. Code § 49.46.090 (authorizing Director of Washington Department of Labor and Industries to take legal action on behalf of employees for wages owed); Wash. Rev. Code § 49.48.030 (authorizing Department to investigate claims of unpaid wages and order payment of wages owed).

While in most bankruptcy cases the States do not intervene but allow employees to file their own claims, in appropriate cases they do. *See, e.g., Midway Games, Inc. et al. v. Catherine D. Shannon, Director of the Ill. Dep't. of Labor, et al.* (Case No. 09-52288, Bankr. D. Del.) (Illinois Department of Labor negotiated settlement with debtors providing for payment of wages); *Pascazi v. N.Y. State Dep't of Labor* (*In re Fiber Optek Interconnect Corp.*), Case No. 15-CV-8530 (VB) (New York Department of Labor negotiated settlement providing for debtor's payment of wages due under New York prevailing wage law, New York Labor Law § 220); *In re St. Vincent's Catholic Med. Ctrs.*, 445 B.R. 264 (Bankr. S.D.N.Y. 2011) (directing evidentiary hearing on New York State Department of Labor's New York WARN Act claim).

[3] *See, e.g., In re Longo*, 144 B.R. 305 (Bankr. D. Md. 1992) (Maryland Higher Education Commission asserted claims on behalf of students for tuition refunds under consumer deposit priority); *State of Texas v. RS Legacy Corp. f/k/a Radioshack Corp. et al.* (Case No. 15-50870, Bankr. D. Del.) (Texas sued debtors on behalf of its citizens to recover on unredeemed gift cards).

tax claims in excess of $3.5 billion.[4] While the current level of bankruptcy filings is a little lower than the level that existed at the time the survey was taken,[5] adjustment for inflation would suggest that total outstanding tax claims probably do not fall far short of that $3.5 billion figure today, if at all. And this amount does not include taxes claimed by county and municipal governments.

Debtors, like all other entities, are not exempt from the dues they owe to society in the form of taxes, which are the "lifeblood of government." *Bull v. United States*, 295 U.S. 247, 259 (1935). Yet parties to a chapter 11 case will be much less likely to respect the priority of tax claims if they are able to strike a deal that favors their own *ad hoc* priorities. After all, paying taxes will rarely be viewed as desirable by other creditors, particularly where the debtor is liquidating.[6] And history shows that unsecured creditors' committees often take advantage of their role in bankruptcy cases to obtain payments from settlement proceeds or other sources for general unsecured creditors while leaving priority tax claims unpaid. *See, e.g., In re ICL Holding Co., Inc.*, 802 F.3d 547 (3d Cir. 2015); *Official Unsecured Creditors' Comm. v. Stern (In re SPM Mfg.*

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[4] "State Bankruptcy Survey Results," 29 Bankr. Ct. Dec. (LRP) Weekly News & Comment (LPR) A 1, 6, 10-11 (Nov. 19, 1996).

[5] Bankruptcy filings totaled 926,601 in 1995 and 844,495 in 2015, a decline of approximately 9%. https://s3.amazonaws.com/abi-org/Newsroom/Bankruptcy_Statistics/Total-Business-Consumer1980-Present.pdf

[6] *See In re Scott Cable Co.*, 259 B.R. 536 (Bankr. D. Conn. 2002), for an example of the elaborate lengths to which a debtor went in an attempt to deprive taxing authorities of their rights to capital gains taxes.

Corp.), 984 F.2d 1305 (1st Cir. 1993). Indeed, in this very case, the first choice of the settling parties was to eliminate payment not only to the employees but also to the taxing authorities. Although the proposed settlement was revised after the taxing authorities objected, this case exemplifies the risk that settling parties will seek to ignore the Code's prescribed treatment of taxes.

To enforce debtors' tax obligations and to protect government interests, Congress created an intricate set of specific claim priorities, discharge exceptions, lien treatments, and plan payment requirements in the Code applicable only to taxes. *See* §§ 503(b)(1)(B), 507(a)(1) & (8) (establishing priorities for taxes); § 523(a)(1) (establishing discharge exceptions for taxes); §§ 362(b)(9)(D), 362(b)(18) and 724(b) (establishing special rules for tax liens); and § 1129(a)(9)(C) (establishing standards for repayment of taxes in a chapter 11 plan).

These tax-related provisions are predicated on the principle that bankruptcy cases will be resolved in a manner that respects the Code's priority scheme. In a chapter 11 reorganization, for instance, while the debtor has substantial freedom in structuring the treatment of classes of claims, § 1129(a)(9)(C) mandates a precise minimum treatment for tax claims under a plan; in return, tax claimants are not allowed to vote on the plan. *See* § 1123(a)(1) (priority tax claims are not classified for plan confirmation purposes) and § 1129(a)(7)–(8) (only impaired classes can vote). Thus, unlike general unsecured creditors, tax claimants cannot persuade a more senior creditor to accord them added consideration to obtain their votes, but on

the other hand they can depend on the protection provided by the Code. Likewise, in liquidations under chapter 7, the taxing authority can insist on receiving payment in accordance with the § 507 priorities. *See* § 726. If those carefully wrought provisions can be sidestepped by approval of a "structured dismissal" that ignores the Code's priorities whenever parties make plausible arguments that they have devised a better order of payment under the facts of a particular case, little will remain of the protections Congress enacted.

The *Amici* States submit that even in those situations where a conditional dismissal is appropriate, the assets of the estate must be distributed in compliance with the priorities ordained by Congress. The Third Circuit's decision to the contrary ignores both plain statutory language and the legislative design and undermines States' congressionally conferred rights in bankruptcy proceedings.

STATEMENT OF THE CASE

A subsidiary of Sun Capital Partners ("Sun"), a private equity firm, bought the debtor, Jevic Transportation, Inc. ("Jevic"), a trucking company, in a leveraged buyout in 2006 through a transaction that involved using Jevic's own assets to finance the purchase price. App. 2a. Shortly afterwards, Jevic refinanced this new debt with a loan from CIT Group/Business Credit, Inc. ("CIT"), and granted CIT a first lien on all of its assets. App. 2a, 36a. Jevic was already in financial distress when it was acquired; by 2007, it was no longer able to service the new debt and was in default on the loan from CIT. App. 2a. Jevic signed a forbearance with CIT in early 2008 that resulted in its new owner, Sun, agreeing to guarantee $2 million of the CIT loan. *Id.*

Jevic was unable to maintain compliance with the terms of that forbearance, and it expired in early May 2008; on May 19, Jevic notified its employees that the company was closing and that they would be laid off shortly. *Id.* It filed its bankruptcy petition on May 20, 2008. App. 3a. Nearly 1,800 Jevic truck drivers who were laid off without warning filed a class action suit in the bankruptcy court under the federal Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101–2109 (the "WARN Act") and a similar state WARN Act in New Jersey, the Millville Dallas Airmotive Plant Job Loss Notification Act, N.J. Stat. Ann. §§ 34:21-1 to -7, both of which require notice to employees before plant closings or mass layoffs.

The employees sued both Jevic and Sun, alleging that Sun was a joint employer with Jevic and so

could be held jointly liable for the violations. App. 3a, 37a. The employees estimated that their claim was worth $12.4 million, of which $8.3 million was assertedly a priority claim under § 507(a)(4) for unpaid wages. App. 5a–6a.

As a result of Jevic's bankruptcy, fraudulent transfer claims against CIT and Sun, which otherwise could have been asserted by any unsecured creditor, could only be asserted by Jevic as the debtor in possession. *See* 11 U.S.C. § 544(b)(1); *Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 581 (3d Cir. 2003) ("The plain text of § 544 makes clear that only the trustee may invoke the remedies under the statute."); 11 U.S.C. § 1107(a) (debtor in possession generally has the functions and duties of a bankruptcy trustee).

By order of the bankruptcy court, Jevic's Unsecured Creditors' Committee (the "Committee") was given authority to bring suit in that court against Sun and CIT on the estate's behalf, based on a claim that the leveraged buyout was a fraudulent transfer that had saddled Jevic with debts it could not possibly expect to pay and thus hastened its financial collapse. App. 3a. The Committee's complaint survived a motion to dismiss with respect to the fraudulent and preferential transfer counts, and the Committee filed an amended complaint with respect to the other counts. App. 3a–4a, CAJA 764. The remedy sought in the complaint was the avoidance of all liens held by CIT and Sun and the recovery of all buyout-related transfers from Jevic to CIT and Sun made in the buyout. App. 54a. Those transfers exceeded $100 million,

well in excess of the $20 million owed to creditors other than CIT and Sun. CAJA 770–772, App. 3a.

By the time the decision issued on the motion to dismiss at the end of 2011, however, the estate's assets had dwindled to the Committee's causes of action against CIT and Sun and about $1.7 million in cash, which was subject to Sun's lien (although the lien was disputed). App. 4a. There were a number of outstanding administrative expenses that could not be satisfied in light of Sun's *prima facie* lien on the available cash. App. 4a–5a. And although discovery had been proceeding for some time, the WARN Act litigation was still unresolved. App. 5a–6a.

Accordingly, in early 2012, several parties—Jevic, Sun, CIT, the Committee, and the employees (but not the taxing authorities)—sought to negotiate a global resolution of the case. App. 4a. In the end, an agreement was reached by all those involved in the negotiations except the employees. The agreement provided that (a) Jevic, Sun, CIT, and the Committee would release each other, and the fraudulent conveyance action would be dismissed with prejudice; (b) CIT would contribute $2 million that would be used to pay some of Jevic's administrative expenses and legal expenses of the Committee; (c) Sun would release its lien on the $1.7 million in cash and those funds would be used to pay Jevic's remaining administrative expenses and the tax claims, as well as about 4% to general unsecured creditors;[7] and (d) Jevic's bankruptcy

[7] The original version of the settlement would have devoted the entire $1.7 million to the general unsecured creditors, but after objections from the United States Trustee, priority tax creditors, and the employees, that aspect of the settlement was revised to

case would then be dismissed. App. 5a. The claims of the employees were left out of the settlement entirely, even though some of those claims held priority status. App. 5a–6a. Sun's counsel conceded in the bankruptcy court hearing that the settlement was structured to ensure that the employees would not receive any estate funds that could be used to help continue their pending WARN Act litigation against Sun.[8] App. 6a–7a, n. 4.

The bankruptcy court, the district court, and the panel majority in the Third Circuit all concluded that the settlement should be approved, even though it concededly did not follow the priority rules that would have been applicable if the Debtor had sought to confirm a plan in Chapter 11 or if it had converted its case to a Chapter 7 liquidation. App. 53a–61a, 42a, 23a. In its decision, the Third Circuit first concluded that where there was no prospect of a confirmed plan and where the secured lenders would not have agreed to the same settlement or to the use of the encumbered cash in a chapter 7 case, a bankruptcy court may approve a settlement and enter a related "structured dismissal" order provided those actions were not done to evade the protections and safeguards of plan confirmation or conversion to chapter 7. App. 12a–15a. It

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ensure that the administrative and priority tax claims were paid. App. 3a, n.1.

[8] In May 2013, after the settlement, the bankruptcy court entered summary judgment against Jevic on the undisputed state WARN Act claim. App. 5a–6a, n.2. At the same time, it rejected the allegation that Sun was a joint employer with Jevic and dismissed the litigation with respect to Sun. *Id.* Due to the settlement and distribution of all estate assets, the finding that Jevic was liable did not result in payment to the employees.

further concluded that because nothing in the Code explicitly requires that a settlement agreement satisfy the Code's priority requirements, a settlement could be approved under Rule 9019 of the Federal Rules of Bankruptcy Procedure so long as it was "fair and equitable," App. 11a, and that a priority-skipping settlement could meet that standard, App. 21a. Upon approval of the settlement, the Third Circuit reasoned, a court could dismiss the case in reliance on the "for cause" standard in § 1112(b) and the court's powers under § 349. Although it asserted that such a result would be "justified only rarely," it found this settlement acceptable because it was the "least bad alternative," in that it provided payment to a number of unsecured creditors (from the release of Sun's disputed lien on estate assets), not just the secured lenders, even if it did so at the expense of higher priority creditors who were entitled to be paid ahead of those general unsecured creditors. App. 21a.

Judge Scirica dissented. *Id.* He explained that a party such as Sun should not be able to dictate the structure of distribution of the estate to serve its own interests and that the actions of the settling parties here did nothing to maximize estate assets, but rather served only to direct them to preferred creditors. App. 25a–26a. The dissent also warned that this decision would become a template for parties in future cases to shape estate distributions for their individual benefit rather than in accordance with the Code's priorities. App. 31a. After noting the high level of secured debt owed by many debtors currently filing for chapter 11, he stated, "It is not difficult to imagine another secured creditor who wants to avoid providing funds to priority unsecured creditors, particularly where the

secured creditor is also the debtor's ultimate parent and may have obligations to the debtor's employees." *Id.* Thus, Judge Scirica concluded, "approval of the bankruptcy court's ruling in this case would appear to undermine the general prohibition on settlements that deviate from the Code's priority scheme." *Id.*

SUMMARY OF ARGUMENT

The Bankruptcy Code provides that a corporate debtor can exit bankruptcy via one of three avenues: liquidation under chapter 7, a plan of reorganization or liquidation under chapter 11, or dismissal of the bankruptcy case. Under chapter 7, all estate assets must be liquidated and their proceeds distributed in accordance with § 726, which incorporates by reference the detailed priority scheme set out in § 507. Under chapter 11, any plan must conform to various Code provisions, including § 1129(a)(7), which requires that each creditor must receive as much as it would in a chapter 7 liquidation; § 1129(a)(9), which requires that priority creditors be paid in full unless they agree otherwise; and § 1129(b), which provides that junior creditors cannot receive anything until senior creditors are paid in full—the so-called "absolute priority rule."

If a case cannot be resolved under either chapter 7 or 11, it must be dismissed. A dismissal ordinarily "revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case." § 349(b)(3). The bankruptcy court may depart from this strict revesting requirement only "for cause." *Id.* While the legislative history indicates that the for-cause exception may be used to protect rights acquired in reliance on the bankruptcy case, such as those of good-faith purchasers of property from the estate, nothing in § 349 or its legislative history authorizes the use of dismissal to distribute all of the estate's assets to creditors. Such a sweeping reading of § 349 would defeat the purpose of dismissal, which is to return the parties as nearly as

possible to the prepetition status quo ante. And even if § 349 could be construed to authorize the distribution of all estate assets, allowing distributions that flout the absolute priority rule would upset the carefully wrought scheme Congress created in the Bankruptcy Code as a whole.

Settlements in bankruptcy, whether they are negotiated outside the plan confirmation context or as part of plan confirmation, may be approved only if they allow the debtor to conclude its case in accordance with the Code's requirements. Settlements do not necessarily involve distribution of proceeds, but under chapter 7 and 11 any distributions pursuant to settlement must be made in accordance with the priority scheme. In a dismissal—assuming the bankruptcy court has the discretion under § 349 to allow distribution of all of the estate's assets to creditors—such a distribution must likewise honor the Code's priorities.

If this Court affirms the decision below, the rights of priority creditors will be eroded. Although the Third Circuit purported to limit its holding to "rare instances," App. 12a, history has shown that rare instances tend to proliferate in bankruptcy practice, and that what was once exceptional can quickly become the norm. A bright-line rule is necessary to ensure that dismissal and settlement are not used to circumvent the priority rules that Congress placed at the center of the entire bankruptcy process.

ARGUMENT

I. Disposition Of Bankruptcy Cases Must Conform To The Priority Scheme That Lies At The Heart Of The Code.

Debtors can file under one of five chapters of the Bankruptcy Code, assuming they meet the eligibility criteria set out in § 109. Individuals have the option of filing under chapter 7, 11, 12 or 13; municipal entities can file under chapter 9; family farmers and fishermen can file under chapter 12; and corporate debtors have the option to file under chapter 7 or 11.[9] Although the same principles apply in all chapters, because the vast majority of cases involving settlements or dismissals that disregard the Code's priority scheme arise in corporate cases, the *Amici* States' analysis will focus on corporate filings under chapter 7 or 11.

A corporate debtor may file under chapter 11 to confirm a plan of reorganization or of liquidation. Alternatively, the debtor may move to convert its chapter 11 case to chapter 7 or it may opt to liquidate by filing its case initially under chapter 7. Once in chapter 7, it must turn over its assets to a trustee to be liquidated and distributed. Whether a case is in chapter 7 or 11, the debtor or a party in interest may move to dismiss the case "for cause." *See* §§ 707(a) &

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[9] Foreign entities filing for bankruptcy in a foreign jurisdiction may also obtain assistance from a U.S. bankruptcy court via a chapter 15 petition. *See* § 1501 *et seq.*

1112(b). Section 349 describes the legal effect of a dismissal, which generally entails restoration of the prefiling status quo to the greatest extent possible unless the bankruptcy court, for cause, orders otherwise. *See* § 349(b).

When a case is resolved through a confirmed plan under chapter 11, the requirements of § 1129 must be satisfied. These include the "best interests of creditors" requirement, *i.e.*, that each creditor must receive as much as it would have in a chapter 7 liquidation, § 1129(a)(7); the requirement that priority claims be paid in full unless the creditors agree otherwise, § 1129(a)(9); and the requirement that the plan be "fair and equitable" with respect to any dissenting class of creditors, § 1129(b)(1). Section 1129(b)(2), in turn, defines "fair and equitable" to mean that each class of unsecured creditors must be paid in full or else "the holder of any claim or interest that is junior to the claims of such class will not receive or retain any property"—the so-called absolute priority rule.

When a case is resolved under chapter 7, after secured creditors claim their collateral, unsecured claims from the remaining estate assets are paid out in accordance with § 726. That provision, in turn, incorporates the priorities specified in detail in § 507, among which are priorities for administrative expenses, employee wage and benefit claims, consumer deposits, and most taxes. General unsecured claims are paid only if there are sufficient funds to satisfy all of the priority claims.

Finally, there is a third way in which a chapter 7 or 11 case can be disposed of: the debtor or other

parties in interest may move to dismiss under § 707(a) or § 1112(b)(1). The effects of dismissal are spelled out in § 349. As relevant here, § 349(b) states that unless the court "for cause" orders otherwise, dismissal reinstates any prior custodianship and any liens that were avoided under § 506(d); reverses the results of avoidance actions; vacates actions taken under several other sections that serve to bring assets into the estate; and revests property of the estate in the entity in which such property was vested prior to the filing, usually the debtor. The net result of these provisions is to return the parties to the prefiling status quo as nearly as possible.

The legislative history of § 349 reflects a clear congressional intent that the dismissal of a bankruptcy case should "undo the bankruptcy case, as far as practicable, and ... restore all property rights to the position in which they were found at the commencement of the case." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 338 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6294; S. Rep. No. 95-989, 95th Cong., 2d Sess. 48 (1978), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5835. The clause "unless the court, for cause, orders otherwise" was included to allow courts to protect certain transactions undertaken in reliance on the case. As the legislative history explains, § 349(b) "does not necessarily encompass undoing sales of property from the estate to a good faith purchaser. Where there is a question over the scope of the subsection, the court will make the appropriate orders to protect rights acquired in reliance on the bankruptcy case." *Id.*

The § 349(b) exception to revesting is thus a narrow one that does not empower the bankruptcy court to use dismissal to accomplish outcomes not otherwise authorized by the Code. Notably absent from the Code is any provision allowing the court to use dismissal as a basis for distributing estate assets (except by returning them to the original holders), resolving disputed claims or making payments on such claims, or precluding parties from asserting rights they would have enjoyed prior to the bankruptcy. To the contrary, dismissal is designed to terminate the case and remit the parties to their prepetition remedies.

Even if the "for cause" exception of § 349(b) were construed as allowing the court to authorize the distribution of all estate assets, it would do violence to the purposes of the Code to allow such a distribution to disregard the carefully crafted priority scheme set forth in § 507. The priorities codified there represent a considered legislative judgment about the social importance of competing claims. *See* S. Rep. No. 1106, 95th Cong., 2d Sess. 4 (1978) (noting that the Code "giv[es] priority in the distribution of assets of the debtor's estate to certain claims with special social importance"); *cf. United States v. Noland*, 517 U.S. 535, 541 (1996) ("Decisions about the treatment of categories of claims in bankruptcy proceedings ... are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination.") (quoting *Burden v. United States*, 917 F.2d 115, 120 (3d Cir. 1990) (Alito, J., concurring in part and dissenting in part). It would be an abuse of the bankruptcy process for dismissals under § 349 to be used

in a manner that disregards those legislative judgments and circumvents the outcomes contemplated by chapters 7 and 11.

Nor can the bankruptcy court arrogate to itself additional powers with respect to dismissal by reliance on § 105(a), which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." As the text of § 105(a) makes clear, it can only be used to assist in implementing existing provisions of the Code, not to further the policy preferences of the court or the parties. *Cf. Law v. Siegel*, 134 S. Ct. 1188 (2014). If the bankruptcy court cannot identify a specific Code provision that justifies the use of a § 105 order, its authority is at an end. *See, e.g., In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004) (Section 105(a) "does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override."); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Management)*, 4 F.3d 1329, 1334 (5th Cir. 1993) (bankruptcy court could not use Section 105 to authorize approval of settlement that would pay prepetition commissions from postpetition estate assets, contrary to Code's priorities); *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986) (Section 105(a) "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity").[10]

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[10] Although the title of the bankruptcy court's order cited § 105(a), App. 45a, we note that Respondents appear to have disavowed any reliance on that provision. Br. Opp. 18 n.3.

II. Settlements In Bankruptcy Cases That Prevent A Case From Terminating In Accordance With The Priority Scheme Cannot Be Approved.

As described in Part I, *supra*, there are three ways in which a corporate bankruptcy case can terminate: liquidation under chapter 7, a plan of reorganization or liquidation under chapter 11, or dismissal. When a case is filed and prosecuted in good faith, the operations of the debtor-in-possession or trustee should be directed towards reaching one of the first two goals. It is only if the debtor-in-possession or trustee cannot meet either of those goals (or becomes able to satisfy all claims outside of bankruptcy) that its actions should devolve into a dismissal.

Prior to reaching any of these three endpoints, the debtor-in-possession or trustee will have many occasions to resolve disputed issues, from questions about the ownership of assets, to the validity of claims by and against the debtor, to litigation over causes of action belonging to the estate. When parties reach a settlement of such disputes, bankruptcy courts have the procedural power to review and approve them under Rule 9019. That Rule contains no explicit substantive standards. It states:

> (a) Compromise. On motion by the trustee and after a hearing on notice to creditors, the United States trustee, the debtor and indenture trustees as provided in Rule 2002 and to such other entities as the court may designate, the court may approve a compromise or settlement.

In a run-of-the-mill dispute, such as one involving whether a particular claim is meritorious, the debtor-in-possession or trustee is accorded substantial deference in determining whether to compromise the estate's position, taking into account the chances of success, the costs of litigation, and the possible benefits to be achieved. *See In re Age Refining, Inc.*, 801 F.3d 530, 540 (5th Cir. 2015); *In re Martin*, 91 F.3d 389, 393 (3d Cir. 1996). Such settlements are not sought or approved for their own sake but rather as a means to the ultimate resolution of the case through one of the three permissible avenues: a chapter 11 plan, a chapter 7 liquidation, or a dismissal. Settlements that preclude lawful implementation of these three methods of closure cannot be a proper use of the court's powers.

That was this Court's square holding with respect to settlements entered into as part of a chapter 11 plan in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968). In *TMT Trailer*, this Court explained that the requirement that plans be "fair and equitable" applies to "compromises just as to other aspects of reorganizations." *Id.* at 424.[11] The "fair and equitable" standard, the Court noted, incorporated the absolute priority rule, which precludes shareholders from recovering unless creditors are paid in full. *Id.* The Court thus overturned a bankruptcy court's "perfunctory" approval of a trustee's "conclusory" de-

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[11] At the time of *TMT Trailer*, the "fair and equitable" requirement was codified at §§ 174 and 221(2) of Chapter X of the Bankruptcy Act, 52 Stat. 891, 897, 11 U.S.C. §§ 574, 621(2) (1968).

cision to allow certain claims in full over strenuous objections from the stockholders and the Securities and Exchange Commission. *Id.* at 434, 454.

The lesson of *TMT Trailer* is that whether a settlement is "fair and equitable" depends not just on the issues between the settling parties but also on the effect of the settlement on the other parties in interest. A narrow reading of that case that confined its holding to settlements entered into as part of a chapter 11 plan confirmation would only invite gamesmanship. If parties could avoid application of the absolute priority rule or other constraints in the Code by reaching a settlement that contemplates distribution of proceeds so long as they do so separately from the plan confirmation process, the creditor protections recognized in *TMT Trailer* would quickly become a nullity.

That lesson was recognized by the Fifth Circuit in *In re AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984). *AWECO* involved a settlement in a case with four primary creditors: the Department of Energy, the Internal Revenue Service (IRS), a private creditor with a claim secured by a judgment lien on most assets, and a second private party, United, that had been in litigation with the debtor. The debtor and United reached a settlement of United's claim that provided for the actual transfer to United of some $5.3 million in assets, including property that secured the private claim and at least $4 million of the tax claims. *Id.* at 295–96. The IRS and the Department of Energy objected on the basis that they had equal or higher priority claims to that of United and that the evidence did not clearly establish that the debtor would be able

to pay them on an equal basis with United if the settlement was approved and those assets left the estate.

The bankruptcy court found that the settlement provided the debtor with its only chance to reorganize and that this result would be in the best interests of all creditors. *Id.* at 296-97 In holding that the court had abused its discretion by approving the settlement, the Fifth Circuit emphasized that the holding of *TMT Trailer* extends beyond the confirmation context:

> As soon as a debtor files a petition for relief, fair and equitable settlement of creditors' claims becomes a goal of the proceedings. The goal does not suddenly appear during the process of approving a plan of compromise.

Id. at 298. Allowing an estate to be depleted by paying junior claims based on settlements that were fair as between the settling parties but that did not ensure retention of sufficient funds to pay senior creditors would violate the absolute priority rule. *Id.*

This point is perhaps most plainly illustrated in the chapter 7 context. If a chapter 7 trustee enters into a pre-distribution settlement that violates the Code's priority scheme, leaving the estate with insufficient assets at the time of distribution to pay claims in accordance with the priorities set forth in § 726, the settlement puts the trustee in conflict with his statutory duties under § 726.

As explained in Part I, *supra*, § 349 does not authorize bankruptcy courts to use dismissal as a vehicle to distribute estate assets, much less to distribute them in a way that violates priority. And as this Part has shown, courts cannot use their settlement approval authority to achieve the same result. The bankruptcy court's expedient in this case—cobbling together settlement and dismissal into a so-called "structured dismissal"—should fare no better. Courts must ensure that dismissals accomplish the revesting imperative of § 349 as nearly as possible, and that settlements are consistent with the standards used to effect a chapter 7 distribution or a chapter 11 plan. They must be equally vigilant in ensuring that the settlement-plus-dismissal approach is not used to achieve a result that is inconsistent with what the Code allows. Section 349, either alone or in combination with § 105(a), cannot give a bankruptcy court the power to distribute estate assets in whatever way seems to the judge to be the "least bad alternative."

III. A Bright-Line Rule Prohibiting Priority-Skipping "Structured Dismissals" Is Necessary To Fully Protect Creditors.

The Third Circuit in this case admitted that "the Code does not expressly authorize structured dismissals," App. 13a, conceded that "[t]he Drivers' argument [against structured dismissals that violate priority] is not without force," App. 16a, recognized the "justifiable concerns about collusion" raised by priority-skipping settlements, App. 20a, and characterized the case overall as "a close call," App. 21a. Nonetheless, it concluded that this was the "rare case"

in which a structured dismissal could be approved despite distributing estate assets in a manner that failed to conform to the Code's priority system. App. 2a. In an attempt to place some limits on its holding, the Third Circuit announced that "compliance with the Code priorities will usually be dispositive of whether a proposed settlement is fair and equitable," App. 20a, and cautioned that "bankruptcy courts may approve settlements that deviate from the priority scheme of § 507 of the Bankruptcy Code only if they have 'specific and credible grounds to justify [the] deviation.'" App. 21a (quoting *In re Iridium Operating LLC*, 478 F.3d 452, 466 (2d Cir. 2007)). History and practice demonstrate, however, that any attempt to cabin the use of priority-skipping "structured dismissals" is likely to prove futile, and that a bright-line prohibition is needed.

The need for a firm rule is demonstrated by the aftermath of *Iridium*, the Second Circuit case whose "flexible approach" was adopted by the Third Circuit here. App. 18a. In *Iridium*, the bankruptcy court addressed the settlement of an action brought by the unsecured creditors' committee on behalf of the estate against a group of lenders. The settlement arguably deviated from the absolute priority rule in that it distributed estate assets to a litigation fund established to finance the committee's suit against Motorola while skipping Motorola, which had itself asserted a priority administrative claim. 478 F.3d at 459. The Second Circuit upheld this aspect of the settlement notwithstanding the possible deviation, reasoning that the alternatives to settlement posed too much risk to the estate and its administrative creditors. *Id.* at 465–66. It went on to hold that although compliance with the

Code's priority scheme will "often be the dispositive factor" in reviewing a settlement, priority-skipping settlements may be approved "where the remaining factors weigh heavily in favor of approving a settlement." *Id.* at 464.[12]

Iridium's balancing test was unstable from the outset. The most notable evidence of this instability is the instant case itself, in which the Third Circuit permitted senior and junior parties to squeeze out all of the rights of an intermediate class of creditors. Although *Iridium* suggested that pre-plan settlements that varied "in some minor respects" from the Code's priority scheme could be approved in certain circumstances, *id.* at 465, it did so in an ongoing Chapter 11 case where the debtor, in order to confirm a plan,

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[12] In fact, it is not clear that the proposed settlement in *Iridium* would have violated the priority scheme by skipping Motorola. After all, using estate funds to sue a potential claimant against the estate (even one that asserts an administrative priority) is itself an administrative expense that may be paid on an ongoing basis. *See* §§ 507(a)(1)(C) & 331; *In re Mariner Post-Acute Network, Inc.*, 257 B.R. 723, 731-32 (Bankr. D. Del. 2000) (authorizing interim payments of professional fees subject to final allowance by court). And the *Iridium* settlement provided for the estate to receive a percentage of the recovery from litigation, which would be used to fund a plan that would pay claims according to their priority—presumably including Motorola's administrative claims if they were ultimately allowed. Moreover, it should be noted that the Second Circuit remanded the case to the bankruptcy court for reconsideration of a separate—and inarguable—deviation from the priority scheme involving the distribution of any amount remaining in the litigation fund after the litigation concluded. 478 F.3d at 466. *Iridium* thus hardly stands as an example of the practical need to reject a *per se* rule against priority-skipping settlements.

would still have to meet the Code's priority requirements. *Id.* at 467. The Third Circuit, however, has extended the *Iridium* holding to approve a non-conforming settlement in conjunction with a dismissal that distributes all of the estate's assets while completely disregarding the priority status of a disfavored class of creditors.

Subsequent cases have further evidenced the erosion of the limitations the Second Circuit attempted to impose on priority-skipping settlements. The Sixth Circuit Bankruptcy Appellate Panel, for instance, has demoted compliance with the Code's priority rule from "the most important factor" in evaluating a settlement to merely "a crucial factor." *Olson v. Anderson (In re Anderson)*, 377 B.R. 865, 870 n.3 (6th Cir. BAP 2007), *abrogated on other grounds by Schwab v. Reilly*, 560 U.S. 770 (2010). And in *In re Tackley Mill, LLC*, 386 B.R. 611 (Bankr. N.D. W.Va. 2008), the court described the Second Circuit in *Iridium* as "indicating that it would approve of a settlement under [Rule 9019] that violated the priority distribution scheme of the Bankruptcy Code so long as *a justification* existed for departing from the Bankruptcy Code's distribution scheme." *Id.* at 615 (emphasis added).

Subjecting the absolute priority rule to such an amorphous standard disserves the goals Congress sought to advance in crafting the Code's intricate priority scheme. All parties in a bankruptcy case need to know the legal structure against which their agreements will be judged, as that structure will determine what leverage they can assert in their negotiations.

The need for dependable priority rules is especially pressing for governmental taxing authorities. As noted in the section on the Interest of the *Amici Curiae*, *supra*, Congress deprived tax claimants of the ability to vote on a plan in exchange for the precise minimum protections for their claims that are built into the Code's priority scheme. If "structured dismissals" are allowed to evade those protections—including, but not limited to, the absolute priority rule—tax claimants would be left highly vulnerable. Indeed, if the parties knew that a settlement could sidestep an otherwise required tax payment, they might well negotiate a higher settlement amount and then point to this as evidence that the settlement is the "least bad alternative" for the estate as a whole, even while it leaves the taxing authorities in the cold.

While both the Second and Third Circuits attempt to keep their holdings narrowly confined, they are unlikely to remain so limited if this Court affirms. Bankruptcy practitioners are justifiably proud of their ingenuity in reaching solutions that maximize returns for their clients, and in practice the courts have shown little appetite for forcing the parties to reach a different result. Thus, what begins as a unique exception quickly becomes the norm. For example, third-party releases, whereby bankruptcy courts extinguish the liabilities of non-debtors, were originally said to be appropriate only in "extraordinary circumstances," but have now become commonplace. *See* Silverstein, *Hiding in Plain View*, 23 EMORY BANKR. DEV. J. 13, 18 (2006) (describing third-party releases as "increasingly common").

Similarly, sales of all of the debtor's assets outside of a confirmed plan used to be unusual and required substantial justification, usually by reliance on the "melting ice cube" theory.[13] Such sales are now the norm, with little effective role for the court:

> The problem with the "melting ice cube" argument is that it is easy enough for the debtor to unplug the freezer prior to bankruptcy. Historically, the best preparation for a successful Chapter 11 reorganization was to file early, husband resources and arrange postpetition financing to give the debtor the best possible chance to continue its business in Chapter 11. Modernly, it is a better tactic to wait until the last minute and then file with no ability to survive in Chapter 11. Unless the bankruptcy judge is willing to show exceptional judicial courage, he or she must approve the sale. While nominally "presiding" over the case, the judge is reduced to a figurehead without any meaningful discretion

In re Humboldt Creamery, LLC, Case No. 09-11078, 2009 Bankr. LEXIS 2470 at *4 (Bankr. N.D. Cal. Aug. 14, 2009).

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[13] "A melting ice cube case is one in which the trustee or debtor in possession asserts that the debtor's assets must be sold under [11 U.S.C. § 363(b)] on an expedited timeframe or the assets will lose all substantial value and, consequently, the estate and all of the debtor's creditors will suffer significant losses." Administrative Office of the U.S. Courts, *Fourth Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (July 2015), at 15.

"Structured dismissals" would quite likely follow a similar path were this Court to affirm. Several commentators have already suggested that the Third Circuit's opinion lays out a roadmap for future parties that wish to use a settlement-plus-dismissal process as a way to avoid the strictures applicable to chapter 11 confirmations and chapter 7 distributions.[14]

A faithful reading of the Code mandates adherence to Congress's priority scheme. The *Amici* States urge the Court to adopt a bright-line rule prohibiting bankruptcy courts from using dismissals or settlements to bring about results that violate the priority scheme. The Third Circuit's amorphous rule allowing deviations where there are "specific and credible grounds" to do so will invite abuse and collusion by favored parties at the expense of the priorities set by Congress in the Code.

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[14] *See, e.g.*, Lipson & Walsh, *ABA Business Bankruptcy Committee Newsletter, In re Jevic Holding Corp.*, at 3 (May 21, 2015), http://apps.americanbar.org/buslaw/commitees/CL160000pub/newsletter/201507/fa_3.pdf; Kajon, *Third Circuit Upholds Structured Dismissal, Despite Deviation From Bankruptcy Code's Priority Scheme* (June 3, 2015), http://www.stevenslee.com/third-circuit-upholds-structured-dismissal-despite-deviation-from-bankruptcy-codes-priority-scheme/; Goffman et al., *Third Circuit Provides Road Map for Structured Dismissals* (May 28, 2015), https://www.skadden.com/insights/third-circuit-provides-road-map-structured-dismissals (similar).

CONCLUSION

The judgment of the Third Circuit should be reversed and the case remanded for further consideration.

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